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IRS's Offshore Bait and Switch: The Case for FAQ 35

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Pursuant to the Bank Secrecy Act, U.S. citizens, residents, and certain other persons must annually report their direct or indirect financial interest in, or authority (whether signatory or other comparable authority) over any bank, securities, or other financial account maintained with a financial institution in a foreign country if, at any time during a calendar year, the aggregate value of all such foreign accounts exceeds $10,000.

Such report is made to the U.S. Department of the Treasury by filing Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR).

Since 2008, the Internal Revenue Service, in cooperation with the U.S. Department of Justice, intensified its efforts to crack down on unreported offshore assets and accounts and curb offshore tax evasion. As part of that endeavor, IRS in 2009 instituted a special Offshore Voluntary Disclosure Program (the 2009 VDP) to encourage taxpayers with unreported offshore accounts to come into compliance with the FBAR reporting requirements.

While the 2009 VDP expired on Oct. 15, 2009, IRS recently announced a new 2011 Offshore Voluntary Disclosure Initiative (the 2011 VDP)[1] for U.S. persons who were unwilling or unable to come forward under the 2009 VDP. The 2011 VDP has harsher terms than the 2009 VDP, including a higher and less flexible overall penalty structure.

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Since the announcement of the 2011 VDP, examiners have repeatedly sought to apply elements of the tougher 2011 VDP penalty structure to taxpayers who entered the 2009 VDP. As discussed in this article, to supplant the 2009 VDP and penalty structure in this way would grossly undermine principles of horizontal equity, good conscience, and fair tax policy.

The 2009 VDP and FAQ 35

The 2009 VDP created a uniform penalty framework for taxpayers who voluntarily came forward and reported their previously undisclosed foreign accounts and assets.[2]

While the IRS Criminal Investigation Division has a long-standing voluntary disclosure practice,[3] taxpayers were often reluctant to come forward due to uncertainty about their liability for potentially onerous civil and criminal penalties. The purpose of the 2009 VDP was to

[1] See IR-2011-14, Second Special Voluntary Disclosure Initiative Opens; Those Hiding Assets Offshore Face Aug. 31 deadline (Feb. 8, 2011).

[2] IRS issued guidance on the 2009 VDP in the form of Frequently Asked Questions (FAQs), which were posted on the IRS website May 6, 2009. The FAQs were modified and supplemented repeatedly through Jan. 8, 2010. The 2009 VDP ran from March 23, 2009, through Oct. 15, 2009. See ''Voluntary Disclosure: Questions and Answers'' available at http://www.irs.gov/newsroom/article/0,,id=210027,00.html.

[3] See Internal Revenue Manual Section 9.5.11.9 (Dec. 2, 2009).

provide greater consistency and predictability to taxpayers in determining their tax obligations and their exposure to civil penalties, while generally eliminating the risk of criminal prosecution.[4]

Since the announcement of the 2011 VDP, examiners have repeatedly sought to apply elements of the tougher 2011 VDP penalty structure to taxpayers who entered the 2009 VDP.

The 2009 VDP generally required participating taxpayers to file correct delinquent or amended tax returns, including information returns and FBARs, for a six-year period covering tax years 2003 through 2008.[5] A taxpayer that came forward under the program would generally pay:

- the unpaid taxes for the six-year lookback period plus interest;
- an accuracy-related penalty of 20 percent on the additional tax due; and
- an additional penalty (the ''offshore penalty''), in lieu of the FBAR penalty that would otherwise apply, equaling up to 20 percent of the highest aggregate account value of the previously unreported foreign accounts during the six-year period.[6]

The guidance issued by IRS for the 2009 VDP specified that if any part of the penalty structure was unacceptable to a taxpayer, that taxpayer's case would instead follow the standard audit process, with all relevant years and issues subject to a complete examination at the conclusion of which all applicable penalties, including information return and FBAR penalties, would be imposed.[7] Such penalties could substantially exceed the 20 percent offshore penalty.

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IRS on June 24, 2009, incorporated Frequently Asked Question 35 (FAQ 35) as part of the framework for the 2009 VDP. FAQ 35 became a critical element for taxpayers evaluating whether or not to participate in the 2009 VDP. FAQ 35 states:

> Voluntary disclosure examiners do not have discretion to settle cases for amounts less than what is properly due and owing. These examiners will compare the 20 percent offshore penalty to the total penalties that would otherwise apply to a particular taxpayer. Under no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes. If the taxpayer disagrees with the IRS's determination, as set forth in the closing agreement, the taxpayer may request that the case be referred for a standard examination of all relevant years and issues. At the conclusion of this examination, all applicable penalties, including information return penalties and FBAR penalties, will be imposed. If, after the standard examination is concluded the case is closed unagreed, the taxpayer will have recourse to Appeals.[8]

FAQ 35 states in no uncertain terms that taxpayers participating in the 2009 VDP shall not, under any circumstances, be required to pay a penalty greater than what they would otherwise be liable for under ''existing statutes.'' The term ''existing statutes'' necessarily includes Title 31, Section 5321(a)(5)(B) of the Bank Secrecy Act, which provides a reasonable cause exception and reduced civil penalties for the non-willful failure to file FBARs.

The 2011 VDP and FAQ 50

The 2011 VDP includes several changes from the 2009 VDP,[9] including a longer lookback period that covers tax years 2003 through 2010. The most significant of these changes for purposes of this discussion are a new penalty framework and a harsher penalty regime.[10]

The IRS field directive memorandum setting forth the 2011 VDP penalty framework provides for an offshore penalty equal to 25 percent (as opposed to the 20 percent offshore penalty under the 2009 VDP) of the highest aggregate account value of the previously unreported foreign accounts during the lookback period.[11]

IRS included the new Frequently Asked Question 50 (FAQ 50), which addresses issues similar to those covered by FAQ 35 of the 2009 VDP, as part of the framework for the 2011 VDP. However, FAQ 50 provides virtually no relief to taxpayers as compared to FAQ 35, specifying that ''[u]nder no circumstances will taxpayers be required to pay a penalty greater than what they would otherwise be liable for under the maximum penalties imposed under existing statutes.''[12] In contrast, FAQ 35 directs examiners to compare the 20 percent offshore penalty to ''total penalties'' under existing statutes[13] without mention of maximums.

FAQ 50 further provides that ''[e]xaminers will compare the amount due under this offshore initiative to the tax, interest, and applicable penalties (at their maxi-

[4] See Statement from IRS Commissioner Doug Shulman on Offshore Income (March 26, 2009).

[5] See Linda Stiff, deputy commissioner for services and enforcement, Memorandum Authorizing Application of Penalty Framework (March 23, 2009).

[6] Id.

[7] FAQ 34; see note 2, supra.

[8] See note 2, supra.

[9] As with the 2009 VDP, IRS issued guidance on the 2011 VDP in the form of Frequently Asked Questions (FAQs), which were posted on the IRS website Feb. 9, 2011. See ''Voluntary Disclosure: Questions and Answers'' available at http://www.irs.gov/businesses/international/article/0,,id=235699,00.html.

[10] See Steven Miller, deputy commissioner for services and enforcement, Memorandum re Authorization to Apply Penalty Framework to Voluntary Disclosure Requests With Offshore Issues (March 1, 2011).

[11] Id.

[12] FAQ 50; see note 9, supra.

[13] FAQ 35; see note 2, supra.

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mum levels and without regard to issues relating to reasonable cause, willfulness, mitigation factors, or other circumstances that may reduce liability) for all open years that a taxpayer would owe in the absence of the 2011 [Offshore Voluntary Disclosure Initiative] penalty regime.''[14]

The Case for Preserving FAQ 35

Reasonable and Foreseeable Reliance

It was both reasonable and foreseeable that taxpayers would specifically rely on FAQ 35 in deciding whether to enter the 2009 VDP, and that tax practitioners would rely on FAQ 35 in advising their clients with respect to such decisions. In practice, taxpayers who entered the 2009 VDP have been afforded relief from the 20 percent offshore penalty on the basis of FAQ 35 when such taxpayers established that their failure to file FBARs was non-willful or due to reasonable cause.

Since the announcement of the 2011 VDP, examiners have sought to apply the tougher standards of FAQ 50 in lieu of FAQ 35 to taxpayers who entered the 2009 VDP. FAQ 50 specifically relates to the 2011 VDP and bears no relation to the 2009 VDP, nor was it even in existence at the time any taxpayers entered the 2009 VDP.

Taxpayers who entered the 2009 VDP filed their initial disclosures no later than Oct. 15, 2009—16 months prior to the existence of the 2011 VDP and FAQ 50. It goes against all principles of equity and fair tax policy for IRS to tell these taxpayers, many of whom decided to enter the 2009 VDP on the basis of the relief afforded by FAQ 35, that FAQ 35 has gone out the window and that their cases are now analyzed based on FAQ 50.

The justification offered by examiners for disregarding FAQ 35 and instead applying FAQ 50 is their representation that the IRS commissioner never meant for the offshore penalty under the 2009 VDP to be reduced on the basis of concepts such as ''reasonable cause'' or ''non-willfulness,'' and that the commissioner clarified this issue using FAQ 50 in the 2011 VDP. However, IRS has not provided any written guidance to support the application of FAQ 50 to taxpayers in the 2009 VDP.

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It is disingenuous at best for examiners to take such positions, particularly given that FAQ 35 still appears on the IRS website, has not been disavowed by IRS in any official statement or other notice, and has been consistently applied to cases under the 2009 VDP since the program's inception.

It is noteworthy that IRS periodically updated and modified the FAQs relating to the 2009 VDP, but has never made any changes to FAQ 35.[15] Furthermore, an unintended outcome does not provide a valid basis for retroactively changing the treatment of taxpayers in a voluntary program such as the 2009 VDP.

Plain Language

The Tax Court and courts in several other jurisdictions have consistently held that a taxpayer who follows the plain language of a rule or regulation promulgated by the commissioner should receive the tax treatment mandated by such rule or regulation.

For example, in *Woods Investment Co. v. Commissioner*, 85 T.C. 274 (1985),[16] the parent-taxpayer disposed of one of its subsidiaries. IRS and the taxpayer disagreed over the taxpayer's basis in the stock of the subsidiary at the time of its disposition.

Prior to the disposition of the subsidiary by the parent, the subsidiary used accelerated depreciation methods in calculating taxable income. Pursuant to Treasury Regulations Section 1.1502-32(a), the taxpayer made adjustments to its basis in the subsidiary for undistributed earnings and profits. In calculating earnings and profits, the taxpayer used straight-line depreciation (based on Internal Revenue Code Section 312(k)) instead of the accelerated depreciation method used by its subsidiary to calculate taxable income.

IRS argued that the taxpayer must decrease its basis in its subsidiary for the excess amount of accelerated over straight-line depreciation to prevent a ''double deduction.''

The Tax Court rejected IRS's position and held that the taxpayer properly calculated its basis in its subsidiary's stock as required by the regulations. The Tax Court further held that it will not interfere and alter the result mandated by a rule or regulation promulgated by the commissioner and will apply it as written.

The facts of *Woods* are comparable to the scenario discussed herein, and thus, the conclusion reached by the Tax Court in *Woods* should apply to taxpayers in the 2009 VDP. Like the taxpayer in *Woods* who relied on a rule or regulation promulgated by the commissioner in deciding whether to dispose of its subsidiary and determining how to calculate its basis in that subsidiary's stock, taxpayers relied on FAQ 35 in deciding whether to enter the 2009 VDP.

Accordingly, FAQ 35 should not be discarded 20 months after it was promulgated. FAQ 35 should con-

[14] FAQ 50; see note 9, supra.

[15] See note 2, supra.

[16] See also *MCA Inc. v. United States*, 685 F.2d 1099 (9th Cir. 1982); *Trinova Corp. v. Commissioner*, 108 T.C. 68 (1997) (''[T]his Court is not inclined to interfere if the regulations as written support the taxpayer's position . . . we adopted this view even though an 'unwarranted benefit to the taxpayer' might exist.''); *Transco Exploration Co. v. Commissioner*, 95 T.C. 373 (1990); *CSI Hydrostatic Testers v. Commissioner*, 103 T.C. 398 (1994). *Gottesman & Company Inc. v. Commissioner*, 77 T.C. 1149 (1981) (''By no stretch of the imagination should our decision here be construed as calling into question the validity of the existing regulations. We are merely declining to fill in the gaps.'').

tinue to be applied to the relevant taxpayers as in effect at the time such taxpayers entered the 2009 VDP.

Horizontal Equity

The concept of horizontal equity is a traditional test of fairness in the distribution of tax burdens. It has been a cornerstone of tax policy since the founding of this country.[17] Horizontal equity means that taxpayers who are similarly situated should be treated and taxed equally. A brief discussion of this concept as applicable to taxpayers in the 2009 VDP is appropriate.

Until the promulgation of FAQ 50, taxpayers who entered the 2009 VDP could seek relief from the 20 percent offshore penalty pursuant to FAQ 35 if such taxpayers' failure to file FBARs was non-willful or due to reasonable cause. Under the position now taken by examiners, taxpayers who similarly entered the 2009 VDP but have not yet closed their cases are now subject to a much harsher standard, the new FAQ 50.

It would violate the principle of horizontal equity to apply a tougher standard to taxpayers in the 2009 VDP simply because they have not yet closed their cases, compared to similarly situated taxpayers that have already settled their cases and obtained relief pursuant to FAQ 35. To permit such arbitrary and unfair outcomes for similarly situated taxpayers participating in the same program would severely undermine the foundational principles of our system of taxation and deter taxpayers from making voluntary disclosures in the future.

Rewarding the Latecomers

The IRS news release announcing the 2011 VDP specifically noted that ''[t]he overall penalty structure for 2011 is higher, meaning that people who did not come in through the 2009 voluntary disclosure program will not be rewarded for waiting.''[18] However, the position taken by examiners seeking to apply FAQ 50 to taxpayers in the 2009 VDP fails to differentiate between those who waited and those who came forward and made their voluntary disclosures more than 16 months earlier.

To subject taxpayers who entered the 2009 VDP to FAQ 50, which is a key element of the more stringent 2011 penalty structure, would in effect penalize them as compared to taxpayers who enter the 2011 VDP. Such an outcome would be at odds with the intent expressed in the IRS news release.

Conclusion

IRS has repeatedly said that it established the 2009 VDP and issued internal guidance regarding offshore activities in order to ensure that taxpayers are treated fairly, consistently, and predictably.[19] Taxpayers knew what they could expect if they entered the 2009 VDP.

Yet IRS is now pulling a bait and switch, stealthily changing the rules on taxpayers who have already come forward. We hope the IRS commissioner provides practitioners and examiners guidance on this issue and takes the position that FAQ 35 should continue to be applied as written to taxpayers in the 2009 VDP.

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[17] See Auerbach & Hassett, A New Measure of Horizontal Equity (NBER 1999); Galle, Tax Fairness, 65 Wash & Lee L. Rev. 1323 (2008); Graetz, Legal Transitions: The Case of Retroactivity in Income Tax Revision, 126 U. Pa. L. Rev. 47, 79–83 (1977).

[18] See note 1, supra.

[19] ''We believe the [2009 VDP] represents a firm but fair resolution of these cases and will provide consistent treatment for taxpayers. The goal is to have a predictable set of outcomes to encourage people to come forward and take advantage of our voluntary disclosure practice while they still can . . . . This gives taxpayers—and tax practitioners—certainty and consistency in how their case will be handled.'' Statement from IRS Commissioner Doug Shulman on Offshore Income (March 26, 2009). See also FAQ 1; see note 2, supra.

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